ST 08-3
Tax Type: Sales Tax
Issue: Claim Issues – Properly and Timely Filed
Bad Debt Write-Off

STATE OF ILLINOIS
ILLINOIS DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	**No. 00-ST-0000**
	IBT: 0000-0000
	Notice of Tentative Denial of Claim for Sales Tax (October 4, 2005)
v.	
***ABC*, INC.,**	**Kenneth J. Galvin**
	Administrative Law Judge
TAXPAYER	

RECOMMENDATION FOR DISPOSITION

Appearances: Mr. David Hughes, Harwood Marcus & Berk, Chartered, on behalf of *ABC*, Inc.; Mr. John Alshuler, Special Assistant Attorney General, on behalf of the Department of Revenue of the State of Illinois.

Synopsis:

This matter comes on for hearing pursuant to *ABC*, Inc.'s (hereinafter "*ABC*" or "taxpayer") protest of Notice of Tentative Denial of Claim for Sales Tax (hereinafter "Notice") covering the period August 1, 2000 through July 31, 2003 issued by the Department of Revenue (hereinafter the "Department") on October 4, 2005. An evidentiary hearing was held in this matter on August 7, 2007 with testimony from Mr. *Smith*, Sales and Use Tax Director for *Accountants*, Mr. *Jones*, Director of Credit and Legal for *ABC*, and Mr. *John Doe*, Vice-President of Risk Management for *Doe* Finance Organization. Following a review of the testimony, evidence and the record, including the "Stipulation of Facts" submitted by the parties, Taxpayer's Post-Hearing Brief ("TP

Brief"), Department's Response Brief ("Dept. Resp.") and Taxpayer's Reply Brief ("TP Reply"), it is recommended that the Notice of Tentative Denial of Claim for Sales Tax be finalized. In support thereof, the following findings of fact and conclusions of law are made.

Stipulated Findings of Fact[1]:

1. *ABC* operates retail home improvement centers throughout the United States, including Illinois.
2. *ABC* is engaged in the business of selling tangible personal property at retail in Illinois within the meaning of 35 ILCS 120/3 and is required to file a sales and use tax return with the Department pursuant to 35 ILCS 120/3.
3. *ABC* provides its customers with the option of purchasing merchandise through a private label credit card.
4. *ABC* entered into an Amended and Restated Consumer Credit Card Program Agreement with *The Banc* Credit Card Bank of *Anywhere* ("*The Banc*") dated August 4, 1997. (Stip. Ex. No. 1). *ABC* entered into an Amended and Restated Commercial Credit Program Agreement with *XYZ Corporation* ("*XYZ*") and an Amended and Restated Business Credit Card Program Agreement with *MMM* Financial, Inc., both dated August 4, 1997. (Stip. Ex. Nos. 2 and 3). For purposes of this hearing, these documents may be referred to collectively as the "Agreements." Tr. pp. 24-25, 34, 71-74,76-78, 88-89, 92-98.
5. *XYZ* assigned its interest in the Credit Card Program Agreements to *MMM* Financial, Inc.

6. On September 19, 2003, *ABC* timely filed sales tax refund claims ("Refund Claims") with the Department for the periods in issue. Tr. pp. 20-22, 37-48; Stip. Ex. No. 4.

[1] The Stipulated Findings of Fact are numbered the same as the "Stipulation of Facts" submitted by the parties.

7. The amounts that form the basis of the Refund Claims were deducted by *The Banc*, *XYZ* and *MMM* Financial as bad debts on line 15 of their federal corporate net income tax returns (Form 1120). Copies of *The Banc*'s, *XYZ*'s and *MMM* Financial's federal income tax returns (Form 1120) for the 2000-2003 tax years are provided in the record. (Stip. Ex. Nos. 5 through 16). A schedule showing the calculation of the federal bad debt deductions is provided in the record. Tr. pp. 37-38; Stip. Ex. No. 17.
8. On its federal corporate net income tax returns for the 2000-2003 tax years, *ABC* claimed a deduction on line 26 for a "credit card discount" relating to the price paid by *The Banc*, *XYZ* or *MMM* Financial to *ABC* for the accounts covered by the Credit Card Program Agreements. Copies of *ABC*'s federal income tax returns (Form 1120) (page 1 and line 26 detail only) for the 2000-2003 tax years are provided in the record. Tr. pp. 34-36; Stip. Ex. Nos. 18-21.
9. On October 4, 2005, the Department issued a Notice of Tentative Denial of Claim for Sales Tax ("Claim Denial") to *ABC* denying the Refund Claims in the amount of $1,625,697.24. Stip. Ex. No. 22.
10. On November 29, 2005, *ABC* timely protested the Claim Denial. A copy of *ABC*'s November 29, 2005 written protest is provided in the record. Stip. Ex. No. 23.
11. Neither *The Banc* nor *XYZ* are registered with the Department for sales/use tax purposes and neither entity filed sales/use tax returns with the Department for the periods in issue.
12. Neither *The Banc* nor *XYZ* have filed sales/use tax refund claims with the Department based on the same bad debt deductions that comprise *ABC*'s claims.

Conclusions of Law:

The issue to be determined in this case is whether *ABC* is entitled to a refund of sales tax that it remitted to the Department of Revenue at the time of credit card sales, but that taxpayers

subsequently never paid because they defaulted on their credit card accounts. *ABC* operates retail home improvement centers throughout the United States, including in Illinois. Stip. No. 1. *ABC* is engaged in the business of selling tangible personal property at retail in Illinois within the meaning of 35 ILCS 120/3 and is required to file a sales and use tax return with the Department pursuant to 35 ILCS 120/3. Stip. No. 2.

There was testimony at the evidentiary hearing that during the period at issue, from August 1, 2000 through July 31, 2003, *ABC* remitted sales tax of approximately $106 million to the Department. Tr. p. 30; Taxpayer's Ex. No. 1. This amount included sales tax remitted on behalf of private label credit card ("PLCC") customers who purchased goods at *ABC* and subsequently failed to pay for their purchases, including sales tax. Tr. pp. 26-27, 30. On September 19, 2003, *ABC* filed sales tax refund claims with the Department for the periods at issue. Tr. pp. 20-22, 37-48; Stip. Ex. No. 4. *ABC* is seeking a refund of $1,625,697 in sales tax that it paid on behalf of PLCC customers during the period at issue. On October 4, 2005, the Department issued a "Notice of Tentative Denial of Claim for Sales Tax" to *ABC*, denying the refund claims in the amount of $1,625,697. Stip. Ex. No. 22. On November 29, 2005, *ABC* timely protested the claim denial. Stip. Ex. No. 23.

The parties included a copy of the Department's "Notice of Tentative Denial of Claim for Sales Tax" within their stipulated exhibits. Stip. Ex. No. 22. Section 6b of the Retailers' Occupation Tax Act (ROTA) provides that the Department's denial of a taxpayer's claim for credit constitutes *prima facie* proof that the taxpayer is not entitled to a credit. 35 ILCS 120/6b. The Department's *prima facie* case is a rebuttable presumption. The presumption is overcome, and the burden shifts back to the Department to prove its case, only after a taxpayer presents evidence that is consistent, probable and identified with its books and records, to show that the Department's

determinations are wrong. Copilevitz v. Department of Revenue, 41 Ill. 2d 154 (1968); A.R. Barnes & Co. v. Department of Revenue, 173 Ill. App. 3d 826 (1st Dist. 1988).

During the period at issue, *ABC* provided its customers with the option of purchasing merchandise with a PLCC. Stip. No. 3. "A private label credit card is a line of credit, typically a revolving line of credit, that may be used at only one retail outlet, typically the outlet named on the card," in this case *ABC*. Tr. pp. 61-62. The difference between a PLCC and a Visa card is that a PLCC can only be "used at *ABC* or a sister company expo." Tr. p. 63. There was testimony at the evidentiary hearing that most retailers have a PLCC program. "The basic reason to have one is to build customer loyalty, and it expands sales, unlike a general purpose credit card. Because the PLCC can only be used at *ABC*, you have a set line of credit that your customer can only use with the retailer, so it builds sales. … It demonstrably builds loyalty." Tr. p. 64.

ABC could issue its own credit cards by extending credit to customers on a state-by-state basis. Tr. p. 101. There was testimony at the evidentiary hearing, however, that it is virtually impossible for multi-state retailers of *ABC*'s size to issue their own credit cards because complex lending laws vary state by state. "… [I]f you are going to issue your own credit card, you are subject to a 50 state regulation…" Tr. pp. 90, 101, 102. "You have to follow the [individual] state's usury law and late fee laws." Tr. p. 90.

As a result, *ABC* contracts with financial institutions that are authorized to issue credit cards in all 50 states for *ABC*'s PLCC program. During the period at issue, *ABC* entered into an Amended and Restated Consumer Credit Card Program Agreement with *The Banc* Credit Card Bank of *Anywhere* ("*The Banc*") dated August 4, 1997. (Stip. Ex. No. 1). *ABC* entered into an Amended and Restated Commercial Credit Program Agreement with *XYZ Corporation* ("*XYZ*") and an Amended and Restated Business Credit Card Program Agreement with *MMM* Financial,

Inc., both dated August 4, 1997. (Stip. Ex. Nos. 2 and 3). *XYZ* assigned its interest in the Credit Card Program Agreements to *MMM* Financial, Inc. Tr. pp. 24-25, 34, 71-74, 76-78, 88-89, 92-98. The three credit card companies will hereafter be referred to collectively as "*XYZ*."

These credit card agreements included a "Consumer Agreement" which is used by individual cardholders for personal household purchases (Tr. p. 76; Stip. Ex. No. 1), a "Business Agreement," which is used by larger businesses that do not want to pay finance char*ge*s on their credit cards and are therefore required to pay their balance in full each month (Tr. pp. 76-77; Stip. Ex. No. 3), and a "Commercial Agreement," which is a "revolving" agreement that is used by smaller businesses that want to have the option of carrying a credit card balance. (Tr. p. 76; Stip. Ex. No. 2). A "revolving line of credit" means that the cardholder does not have to pay his or her entire balance every month. Tr. p. 62. The three agreements will hereafter be referred to collectively as the "Agreements."

Under the Agreements, customers apply for an *ABC* PLCC by filling out a written application usually obtained at a *ABC* store. "The *ABC* PLCC is advertised in the store, we have signed, promotions, six months same as cash promotions, what have you." Tr. p. 65. Customers submit their application to *XYZ*, which then evaluates the credit-worthiness of the customer and decides whether to open an account and issue them a credit card. Tr. pp. 65-66, 81-84. Once the credit card is issued, the customer can purchase *ABC* merchandise using the PLCC. Tr. pp. 66-67.

The credit card holder does not have a "direct contractual relationship" with *ABC*. "The card-holder opens the account and at all times has a credit relationship with XYZ." *ABC* never owns the accounts or assigns them. The credit card accounts are always owned and serviced by *XYZ*. Tr. pp. 68-69. *XYZ* makes the credit decisions, issues the credit, holds the receivable, collects the receivable and sends out the bills. Tr. p. 73.

In the usual PLCC transaction, a customer purchases an item from *ABC* using his or her credit card. Tr. pp. 23, 66-67; Taxpayer's Ex. No. 3. The customer's card is charged for both the cost of the product and any applicable state sales tax. Tr. pp. 26, 67. *ABC* later remits the sales tax to the Department even though *ABC* has not collected this tax from the customer. Tr. pp. 26-27. *ABC* has not collected the sales tax from the customer at the point of sale because the transaction is a credit transaction. Tr. p. 27. Nevertheless, *ABC* is required to remit the applicable sales tax to the Department when the sale takes place because *ABC* is an accrual basis taxpayer. Tr. p. 27. *XYZ* does not remit sales tax to the Department. Tr. p. 28.

At the time the sale is made, *XYZ* funds *ABC* the full amount of the purchase price, including all applicable sales tax, less an agreed upon service fee. Tr. pp. 27, 73; Taxpayer Ex. No. 3; Stip. Ex. Nos. 1, 2 and 3 ¶ 5.03. The Agreements call the difference between the purchase price and the funded amount a "service fee," but it is referred to as a "credit card discount" on *ABC*'s Federal Form 1120. Tr. p. 80. *ABC* pays this service fee for every PLCC transaction regardless of whether the customer pays to *XYZ* the charge in full or defaults. Tr. pp. 100, 119-120; Stip. Ex. Nos. 1, 2 and 3 ¶ 5.03. The credit card customer is obligated to pay *XYZ* the full amount of the purchase price plus sales tax. *ABC* deducts the service fee for federal income tax purposes. Tr. p. 35; Stip. No. 8. On its federal corporate net income tax returns for the 2000-2003 tax years, *ABC* claimed a deduction on line 26 for a "credit card discount" relating to the price paid to *XYZ* for the accounts covered by the Agreements. Tr. pp. 34-36; Stip. Ex. Nos. 18-21.

86 Ill. Adm. Code § 130.1960(d)(3) states as follows:

> In the case of tax paid on account receivable that becomes a bad debt, the tax paid becomes a tax paid in error, for which a claim for credit may be filed in accordance with Section 6 of the Retailers' Occupation Tax Act, on the date that the Federal income tax return or amended return on which the receivable is written off is filed.

This regulation clearly requires that any claim for credit for tax paid in error must be filed in accordance with Section 6 of the Retailers' Occupation Tax Act. Section 6 provides, in pertinent part, that "no credit may be allowed or refund made for any amount paid or collected from any claimant unless it appears (a) "that the claimant bore the burden of such amount and has not been relieved thereof nor reimbursed therefore and has not shifted such burden directly or indirectly … in any manner whatsoever." 35 ILCS 120/6.

I conclude that there is no basis, in either 86 Ill. Adm. Code § 130.1960(d)(3) or 35 ILCS 120/6, for granting *ABC*'s claims for credit for refund of sales tax. 86 Ill. Adm. Code § 130.1960(d)(3) requires that the tax paid on an account receivable becomes a "tax paid in error" on the date that the Federal income tax return on which the receivable is written off is filed. The claimant in this case, *ABC*, did not write off the unpaid receivables as bad debt on its income tax returns. Rather, the amounts that form the basis of the refund claims were written off by the credit card companies, *The Banc*, *XYZ* and *MMM* Financial, as bad debts on line 15 of their federal corporate net income tax returns (Form 1120) for the years at issue, 2000-2003. Stip. Ex. Nos. 5 through 16. "[The Credit Card Companies] have taken bad debt deductions on line 15 of their federal income tax return related to private label credit cards and specifically including The *ABC* private label credit card transactions." Tr. p. 37. The credit card companies are not the claimants in this case and 86 Ill. Adm. Code § 130.1960(d)(3) does not provide for the situation where one company claims a refund for sales tax paid in error while the unpaid receivables that form the basis for the claims are written off by another company.

The deduction by the credit card companies of the bad debt expense on their federal income tax returns is appropriate in light of the fact that the PLCC accounts are always owned and serviced

by the card companies. *ABC* never owns the credit card accounts.[2] The credit card holder does not have a "direct contractual relationship" with *ABC*. At all times, the credit card holder has a credit relationship with *XYZ*. *XYZ* collects and accounts for payments from the customer, pursues collection options if the customer stops paying, and, in all other ways, services the account. Tr. pp. 68-69, 73. After the sale, *ABC* has no further involvement with the credit card account. The unpaid receivable, including the sales tax, never became a bad debt for *ABC* because *ABC* never owned the account. Because *ABC* never owned the account, the account was never written off by *ABC* as bad debt expense on its federal income tax returns. This precludes *ABC* from filing a claim for credit for sales tax under the Department's administrative regulations.

Further, Section 6 of the Retailers' Occupation Tax Act requires that "no credit may be allowed or refund made for any amount paid or collected from any claimant unless it appears (a) "that the claimant bore the burden of such amount and has not been relieved thereof nor reimbursed therefore and has not shifted such burden directly or indirectly … in any manner whatsoever." 35 ILCS 120/6. In the matter at issue, *ABC* has not borne the burden of the bad debt expense because, as discussed above, the unpaid receivable including sales tax never became a bad debt for *ABC* and was never written off by *ABC* as bad debt expense on its federal income tax return. More importantly, *ABC* has been reimbursed for the receivable and the sales tax through the Agreements with the credit card companies, thereby shifting the "burden" of the bad debt expense directly to the credit card companies.

[2] Assume, for illustrative purposes, that *ABC* maintained its own credit card account, and had remitted sales tax to the Department on an accrual basis. If a customer subsequently stopped paying, *ABC* could write off the account, take a bad debt deduction on its federal income tax return and file a claim for credit with the Department for the amount of the sales tax. Refunding the tax would be an acknowledgment by the Department that no tax is due because no receipts were collected. The important distinction between the credit card sale described in this footnote and the credit card sales at issue in this proceeding is that with the PLCC accounts, *ABC* does not own the accounts, has never, in any way, serviced the accounts and had no rights to the monies paid by the customers to *XYZ* as a result of their purchases. Therefore, *ABC* was not entitled to the bad debt deduction and accordingly, cannot file a claim for credit.

Simply put, *ABC* did not bear the burden of the sales tax it remitted to the Department. After each private label credit card sale is completed, *XYZ* pays *ABC* the full amount of the purchase price, including all applicable sales tax, less an agreed upon service fee or credit card discount. Tr. pp. 27, 73; Taxpayer Ex. No. 3; Stip. Ex. Nos. 1, 2 and 3 ¶ 5.03. The Agreements call this discount a "service fee," but it is referred to as a "credit card discount" on *ABC*'s Form 1120. Tr. p. 80. This service fee is charged for every PLCC transaction regardless of whether the customer eventually pays the charge or defaults. Tr. pp. 100, 119-120; Stip. Ex. Nos. 1, 2 and 3 ¶ 5.03. The service fee percentage varies by transaction time and the use of promotion ("six months same as cash"). At the evidentiary hearing, Mr. *Jones* estimated the service fee at "south of 3%." Tr. p. 115. For illustrative purposes, and assuming that the service fee is actually and consistently 3%, this means that if *ABC* has a PLCC sale of $100 plus $7.45 in sales tax, *ABC* is reimbursed by *XYZ*, in accordance with the Agreements, in the amounts of $97 (97% of $100) for the sale and $7.23 (97% of $7.45) for the sales tax. *ABC* is paid by *XYZ*, whether or not the credit card customer pays the balance in full to *XYZ*.

As this illustration demonstrates, *ABC* has been relieved, through reimbursement, of 97% of the burden of the receivable and 97% of the burden of the sales tax, and has directly shifted this burden to *XYZ*, through the service fee contained in the Agreements. If the PLCC customer stops paying on his account, *XYZ* bears the "burden" of the default, not *ABC*. It is a fact that cannot be ignored that *ABC* has been reimbursed for 97% of the sale and 97% of the sales tax and retains this reimbursement even if the customer subsequently stops paying *XYZ*. In effect, the Agreements relieve *ABC* of the burden of nonpayment by the credit card customer by reimbursing it for the purchase price and sales tax minus the "service fee." 35 ILCS 120/6 does not allow a credit or refund unless it appears that the claimant has not been reimbursed and has not shifted its burden "in

any manner whatsoever." *ABC* has been reimbursed for the sales tax, relieved of the burden of the sales tax and has shifted the burden to *XYZ*. The reimbursement, relief and shifting of the burden preclude *ABC* from receiving credit under 35 ILCS 120/6 of the Retailers' Occupation Tax Act.

I also conclude that *ABC*'s claim for credit must be denied in accordance with § 6a of the Retailers Occupation Tax Act. Section 6a describes the nature of the claim form that a taxpayer seeking a refund of sales tax is required to file (35 ILCS 120/6a), and it provides, in pertinent part:

> § 6a. Claims for credit or refund shall be prepared and filed upon forms provided by the Department. Each claim shall state: (1) The name and principal business address of the claimant; (2) the period covered by the claim; (3) the total amount of credit or refund claimed, giving in detail the net amount of taxable receipts reported each month or other return period used by the claimant as the basis for filing returns in the period covered by the claim; (4) the total amount of tax paid for each return period; (5) receipts upon which tax liability is admitted for each return period; (6) the amount of receipts on which credit or refund is claimed for each return period; (7) the tax due for each return period as corrected; (8) the amount of credit or refund claimed for each return period; …
>
> 35 ILCS 120/6a.

Section 6a makes clear that a taxpayer seeking a refund of sales tax erroneously paid is required to specifically identify, on the face of the amended return, "the total amount of credit or refund claimed, giving in detail the net amount of taxable receipts reported each month or other return period used by the claimant as the basis for filing returns in the period covered by the claim; … receipts upon which tax liability is admitted for each return period; … the amount of receipts on which credit or refund is claimed for each return period; … the tax due for each return period as corrected; … the amount of credit or refund claimed for each return period; [and the] … reason or reasons why the amount, for which the claim is filed, is alleged to have been paid in error …." 35 ILCS 120/6a. The taxpayer's identification of each such amount constitutes a material part of the claim for refund. The amounts are material because they are intended to specifically identify to the

Department the sales tax claimed to have been paid in error on particular sales of tangible personal property.

ABC's claim for credit does not come close to the level of specificity required by Section 6a. Based on a specific request from *ABC*, *XYZ* provided *Accountants* with a "Bad Debt Refund Schedule." Tr. p. 40; Stip. Ex. No. 4. Apparently, when this schedule was generated, neither *ABC* nor *XYZ* knew specifically whether there was sales tax paid on the particular account being written off. For example, the written off amounts may not have been subject to tax because the sales were made to an tax-exempt entity or *ABC* "sold water for something in the agriculture that wasn't subject to tax." Tr. pp. 48-49. To account for the likelihood that some *ABC* sales were not subject to sales tax, *Accountants* "put out a request to the *ABC* sales tax department who performed an analysis of the tax returns in the period of August, 2000, through July, 2003, to come up with what their average non-taxable ratio was for that time frame." "This is an average rate for the State of Illinois." Tr. pp. 45-46. According to the testimony, the average rate of non-taxable sales for the time period at issue was 7.25%. No documents supporting this testimony were provided.

When *XYZ* reported to *Accountants* the "total sales including sales tax" that *XYZ* was writing off, *ABC* reduced this amount by 7.25%, "taking into consideration that some of the purchases were not subject to tax." Tr. p. 46. Mr. Smith testified that the purpose of the adjustment for non-taxable sales "was to have [the] refund claim only include taxable purchases." Tr. p. 49. *ABC* wanted to "ensure" that it "only filed refund claims in situations where it was a private label credit card transaction and it was a taxable transaction." Tr. p. 50.

However, the adjustment for the "non-taxable ratio" does not "ensure" that the sales tax refund claimed by ABC is only for taxable transactions. The refund claim is based on *XYZ*'s unpaid written off receivables for *ABC* PLCC's, and these written off receivables include both

taxable and tax-exempt transactions. *ABC* then discounted the written off amounts by 7.25%, an amount that was a guesstimate. *ABC* is not filing a claim for refund of sales tax on specific sales, as Section 6a would require. *ABC* is filing a claim for refund of sales tax on all receivables written off by *XYZ*, whether sales tax was paid or not, reduced by 7.25%. The "analysis" performed by *ABC* to determine the "non-taxable ratio" for the time period at issue was not offered into evidence.

After the written off amounts are reduced by the "non-taxable ratio," *ABC* applies a "tax rate" of 7.45% to the net amount. The "tax rate" is a "blended rate of all the state and local rates for Illinois at the time that we filed these schedules." Tr. p. 46. There are several problems with this "tax rate." First, it must be noted that counties in Illinois are free to set their own tax rates, within certain parameters. Accordingly, there is no basis for a statewide "blended rate," that does not take into consideration the county in which the purchase was made. Second, the testimony was that the "tax rate" was a "blended rate" at the time that *ABC* "filed these schedules." It is unclear from the testimony whether the "tax rate" used in the schedules was the same tax rate in effect at the time that *ABC* remitted the sales tax to the Department. It is not unreasonable to conclude that the "tax rate" applied to the written off amounts is higher than the tax rate actually remitted by *ABC* at the time of the sale, since sales tax rates in Illinois, historically, have risen. 35 ILCS 120/2-10, and amendments thereto. The "non-taxable ratio" applied to the written off amounts and the "blended tax rate" based on the tax rates at the time the bad debt schedules were prepared, force me to conclude that *ABC*'s refund request does not contain the specific and detailed information required by 35 ILCS 120/6a and precludes the granting of the claim for credit.

ABC next argues that the "service fee" or "credit card discount" includes a component for "bad debt," thereby entitling *ABC* to claim the credit for the tax paid on the receivable which later became a bad debt for *XYZ*. *ABC* argues that it is *ABC*, not *XYZ*, that suffers the economic loss

when a PLCC account goes bad. According to *ABC*, "*ABC* compensated *XYZ* for its bad debts in advance through the various income components of the credit card program, including service fees, late fees, interest and portfolio value." "In fact, anticipated bad debts are a key factor that the parties considered when setting the service fee levels applicable under the Agreements." "By including anticipated bad debt in calculation of the service fee, *ABC* pre-paid or reimbursed *XYZ* in advance for any bad debts that are later incurred." TP Brief, p. 8. *ABC* argues further that "*XYZ*'s profit establishes that *ABC* fully compensated *XYZ* for the costs of bad debts, including lost sales taxes, and therefore bore the economic burden of those losses." TP Reply, p. 3. "The profit earned by *XYZ* is a function of the fact that *ABC* has compensated *XYZ* in advance for anticipated losses on the PLCC accounts." TP Brief, p. 15. Mr. *Jones* testified that bad debt is one of the components of the service fee, and "we prepaid it." "And we know we prepaid it because they [*XYZ*] made money on our portfolio." Tr. p. 120.

I am unable to conclude from the testimony or evidence that *ABC* prepaid or reimbursed *XYZ* for bad debts in advance by paying the service fee/credit card discount. The Department of Revenue is not a party to the Agreements between *ABC* and *XYZ*. There is no evidence to suggest that the Agreements were anything other than a voluntary undertaking by ABC and *XYZ*. *ABC* negotiated the Agreements with *XYZ* based on arms-length bargaining between the companies. *XYZ* profits from the Agreements. Tr. p. 132; TP Brief, p. 8. There is economic benefit to *ABC* from the Agreements, including customer loyalty, expanded sales and unused lines of credit that can only be used at *ABC*. Tr. p. 64. *ABC* made a business decision to enter into the Agreements and was aware of and accepted the provisions.

Quite frankly, the argument that *ABC* prepaid bad debt because *XYZ* made money on the portfolio is misleading and disingenuous. It certainly is not unreasonable to conclude that what Mr.

Jones meant when he said that *ABC* knows it prepaid the bad debt expense "because *XYZ* made money on the portfolio" is that, in retrospect, *ABC* should have negotiated a lower service fee in the Agreements. If *ABC* had negotiated a lower service fee, *XYZ* would not have made money or would have made less money on the portfolio, and, presumably, *ABC* would, therefore, not have pre-paid bad debt. The purpose of the Department's administrative regulations and statutes related to filing claims for credit for tax paid in error is not to relieve a taxpayer from the effects of its business negotiations, its contracts or its bargains. My research does not indicate and counsel for *ABC* did not refer me to any case that holds that a company can file claims for credit in order to get relief from its contracts.

There was considerable oral testimony at the evidentiary hearing as to how the service fee/credit card discount is negotiated and the individual components of the service fee. I conclude from this testimony, however, that the relationship between bad debt and the service fee/credit card discount is so nebulous that it does not support *ABC*'s argument that it prepaid bad debt. The service fee is not described in any of the three Agreements. Each of the Agreements contains a schedule of services fees. The schedule of service fees in the Agreement with *The Banc* Bank is a matrix consisting of the service fee percentage to be charged *ABC*, as a function of the interest rate charged on the credit card purchases (which depends on whether the purchase is greater or less than $2,000), the promotion period and the anticipated "payout rates," which is the percentage of people who are expected to pay off the receivable in time and not pay any interest. Tr. pp. 93-97; Step Ex. No. 2. The other two Agreements contain a schedule of service fees by year. Stip. Ex. Nos. 3 and 4. There is obviously no information in the Agreements or the schedules of service fees that would allow me to conclude that *ABC* prepaid bad debt expense.

To the contrary, with regard to the components of the service fee, Mr. *Jones*, from *ABC*, testified that *XYZ* "expects" four "buckets of money" from the Agreements. First and second, *XYZ* collects interest and late fees from the credit card purchasers. Third, *XYZ* collects the service fee from *ABC*. Fourth, according to the Agreements, the card holders' names and addresses are co-owned by *XYZ* and *ABC*. *XYZ* gets access to "names and dates [that] they can market to for other ancillary products, mortgages and whatnot, or whatever it is they wanted to do." Tr. pp. 79-80. According to the testimony, if the credit card purchasers' profiles indicate that *XYZ* will receive less in interest and late fees, the service fee paid by *ABC* will be higher. Conversely, if the credit card purchasers' profiles indicate that *XYZ* will receive more in interest and late fees, the service fee paid by *ABC* will be less. "I mean, it's part of the negotiation." Tr. p. 79. Thus, the service fee/credit card discount negotiated between *ABC* and *XYZ* obviously varies according to the amount of interest and late fees that *XYZ* anticipates collecting based on the credit card customers' profiles. I am not able to conclude from this testimony that *ABC* prepaid bad debt expense.

With regard to the negotiation of the Agreements, Mr. *Doe*, from *XYZ*, testified that when *XYZ* negotiates agreements of the type at issue in this proceeding, "we make a set of assumptions around the number of accounts, the kind of volume we're going to receive, how many customers we believe will be revolvers and will pay interest, how many will go delinquent, will pay late fees, and what kind of money costs will be in the future, and what kind of losses we would expect to have from that portfolio." "And together we would establish our pricing or fee that we would charge to *ABC* or any other client, based on hitting the returns that we were looking for." "So, if losses are greater or less than, if revenues are greater than or less than, [the] fee that's charged to the client would go up or down based on the inputs in our economic model." Tr. p. 131.

It is clear that the service fee negotiated between *ABC* and *XYZ* contains many different components. I am not able to conclude from Mr. *Doe*'s testimony that any particular component of the service fee was "prepaid" by *ABC*. Nor can I conclude that the fact that *XYZ* made money on the portfolio necessarily indicates that *ABC* prepaid bad debt as Mr. *Jones* testified. It seems equally as likely that *XYZ* made money on the portfolio because they underestimated the number of revolvers and the interest that would be paid over time by these customers. The testimony and evidence admitted at the hearing is insufficient for me to conclude that *XYZ*'s profit is attributable to any particular component of the service fee.

Also, Mr. *Jones* estimated the total service fee as "south of 3%." Tr. p. 115. No estimate was offered by *ABC* as to what component or percentage of this 3% represented "prepaid bad debt." It is impossible for me to conclude that *ABC* prepaid bad debt when there was no testimony as to what dollar amount *ABC* prepaid for bad debt. The fact that *XYZ* made a profit on the portfolio does not signify that *ABC* prepaid bad debt. The service fee/credit card discount is a negotiated amount, consisting of many different components, input into an economic model that depends, in part, on the returns that *XYZ* is looking for. To identify any one of the components as being responsible for *XYZ*'s profit, or to identify any component as being prepaid by *ABC*, is not only unrealistic, but is also not proven by the evidence and the testimony in this case.

ABC's refund claim at issue in this proceeding is for $1,625,697. Stip. Ex. No. 22. *ABC*'s "Credit Card Discount," deducted on line 26 of its Federal Form 1120 for years 2000 through 2003 varies from $424 million (2000) to a high of $518 million (2001). *ABC*'s total "Credit Card Discount" for all 4 years totals over $1.9 billion. Stip. Ex. Nos. 18-21. There is obviously much more, dollar wise, in "Credit Card Discount" than "pre-paid bad debt." As noted previously, the credit card discount is paid by *ABC* for every PLCC transaction regardless of whether the customer

eventually pays the credit card charge or defaults. Tr. pp. 100, 119-120; Stip. Ex. Nos. 1, 2 and 3, ¶ 5.03. The relationship between "prepaid bad debt" and the service fee/credit card discount is so tenuous and imprecise that it would defy reason for me to conclude that bad debt or any component of the service fee had been prepaid.

Finally, *ABC* argues that the denial of its refund claim results in unjust enrichment for the Department. "There is absolutely no question in this case that *ABC* has remitted tax out of its own pocket directly to the Department on PLCC sales." "There is also no question that some customers have defaulted on their credit card obligations." "Although the sales tax deduction is designed to provide relief to a taxpayer in a situation such as this, the Department has refused to allow *ABC* the necessary deduction." TP Brief, pp. 19-20. *ABC* argues that by refusing to allow its claim for credit, the Department is retaining a tax paid in error, resulting in unjust enrichment to the Department.

ABC's argument about unjust enrichment does not make economic sense and is also disingenuous, similar to its argument about prepaying bad debt. For illustrative purposes, assume that *ABC* made a PLCC sale of $100 plus $7.45 in sales tax. The sales tax rate is based on the "blended rate" of 7.45%, discussed previously, which *ABC* used to calculate its claim for credit. *ABC* would then be reimbursed by *XYZ*, in accordance with the Agreements, in the amount of $97 (97% of $100) for the sale and $7.23 (97% of $7.45) for the sales tax. If *XYZ* writes off the entire $100 as uncollectible, *ABC*'s claim for credit would discount the $100 by the "non-taxable ratio" of 7.25%, to $92.75. *ABC* would then claim a credit for $6.90 ($92.75 times the "blended rate" of 7.45%). If the Department allowed the claim for credit, *ABC* would have received $14.13 ($7.23

from *XYZ* and $6.90 from the Department) for the remittance in error of $7.45 in sales tax.[3] Clearly, *ABC* would be unjustly enriched by the granting of its claim for credit.

ABC argues that "unjust enrichment" cannot be analyzed by looking at a single transaction. "The flaw in the Department's analysis is that it examines a single transaction in isolation and does not consider the entire portfolio of credit card accounts as a whole." TP Reply, p. 5. *ABC* pays the service fee on each and every private label credit card transaction. "Thus, *ABC* takes a 'haircut' on every sale even if the customer pays in full. By taking this 'haircut,' *ABC* earns less on <u>every</u> private label credit card sale transaction than it would have earned if it financed the sale itself. The Department, by focusing on a single transaction, fails to account for the haircut that is paid on every sale." TP Reply, p. 6.

This argument is flawed. There is no legal requirement that the Department "account for the haircut that is paid on every sale." The Department is not a party to the Agreements. The Department is not responsible for *ABC*'s election to take a "haircut" on every sale. The "haircut" is a result of Agreements voluntarily negotiated by two resourceful and sophisticated companies. *ABC*, by entering into the Agreements, agreed to earn less on each sale. It has, in turn, determined that it is willing to earn less for sound economic reasons, *i.e.* PLCC customer loyalty to *ABC*, expanded sales and customers with a set, perhaps unused, line of credit on their account that can only be used at *ABC*. Tr. p. 64. *ABC* is not required to enter into the Agreements or any relationship with the credit card companies. For sound business reasons, and after weighing the economic benefits that *ABC* would reap from the Agreements, *ABC* chose to enter into the Agreements with *XYZ*.

[3] The granting of *ABC*'s claim may reap *ABC* another monetary bonus. *ABC* may have remitted less than $7.45 in sales tax to the Department. 35 ILCS 120/3 allows a retailer, at the time of filing a return, to pay the Department the amount of tax less a discount of 1.75% "which is allowed to reimburse the retailer for the expenses incurred in keeping records, preparing and filing returns, remitting the tax and supplying data to the Department on request." Since neither party addressed this point, no consideration of this is made for purposes of this recommendation.

ABC ignores that just as its obligation to pay taxes can only be justified by a statute, its right to a credit for taxes paid exists only because of a statute. People ex rel. Eitel v. Lindheimer, 371 Ill. 367 (1939). Credits, exemptions and deductions from tax are "privileges created by statute as a matter of legislative grace." "Statutes granting such privileges are to be strictly construed in favor of taxation." Balla v. Department of Revenue, 96 Ill. App. 3d 293 (1st Dist. 1981). No section within the Retailers' Occupation Tax Act or the Department's administrative regulations authorizes a credit to be given to a retailer under the circumstances described within the parties' Stipulation. It is not unjust to apply a statute or regulation as written. Village of Chatham v. County of Sangamon, 216 Ill. 2d 402 (2005). I conclude that the only enrichment that might properly be deemed unjust in this case would be occasioned by granting *ABC*'s claims for credit.

For the foregoing reasons, it is my recommendation that the "Notice of Tentative Denial of Claim for Sales Tax" issued to *ABC* on October 4, 2005, be finalized as issued.

ENTER:

Kenneth J. Galvin

March 10, 2008